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BOOK REVIEW

Thorsten Hens and Kremena Bachmann: Behavioural Finance for Private Banking

John Wiley & Sons, 2008

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Frequent interaction with clients is an integral part of modern private banking (banking services offered to wealthy investors). To provide high-quality services, it is thus necessary that advisors understand their clients' behavior and needs, an ability that is evermore important in today's world, as there is ample evidence that clients' experience is increasingly important to their satisfaction, and the ability to provide excellent professional advice is likely to become the main strategy for gaining competitive advantage. For Swiss private banks, this is especially true in light of the recent developments concerning the Swiss bankers' professional duty of client confidentiality. The authors of this entertaining and insightful book show that the field of behavioral finance is particularly suited to understand clients' needs and behavior, and that this field of knowledge can be used to improve clients' experience.

Chapter 1 introduces the current state of private banking and the challenges the industry is facing. The authors point out that while classical finance is useful in understanding financial markets, behavioral finance is the main means by which private bankers will be able to understand clients. Chapter 2 provides the basics of decision theory, which is the scientific foundation of behavioral finance. The authors introduce mean-variance decision theory, the decision model that is best known (and most often taught) in practice, and expected utility theory, the theory that defines which decisions are rational. In addition to these two classical models, the authors introduce prospect theory, developed by Kahnemann and Tversky, which is the very core of behavioral finance. In contrast to the other two decision models, prospect theory attempts to describe which decisions are most likely to be observed in practice.

Chapter 3 lists the main behavioral biases that advisors will most often observe in their clients. Chapter 4 integrates the knowledge developed in Chapters 2 and 3 into a

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highly relevant practical tool—the risk profiler, which is a way to assess a client's risk ability, risk preferences, and risk awareness. The risk profiler helps in dealing with the psychological biases introduced in Chapter 3 because it enables an advisor to decide which of the clients' decisions are rationally based on preferences and which are irrational, and thus need to be corrected.

In Chapter 5, the authors delve into the universe of structured products from the perspective of both expected utility and prospect theory. They show that clients' perceptions of certain products will vary depending on whether the client is an expected utility or a behavioral investor. Chapters 6 and 7 take a dynamic approach and investigate how behavioral effects influence dynamic asset allocation, for instance, how asset allocation should be adjusted over time, and how investment decisions should be structured over an investor's life cycle. Again, the authors show that the decision will be dependent on the framework (expected utility or prospect theory) of the investor. Chapter 8, the final chapter, develops the main elements of the book into an advisory process structured in such a way as to make the best use of the services a bank offers.

In setting out to provide a concise overview of a field as vast as behavioral finance and, at the same time, demonstrate its applicability in practice, the authors set themselves a demanding task—one they accomplished most excellently. True to its title, the book's main focus is on practical client advising rather than asset pricing, and consequently, a reader without formal training in financial economics will be able to grasp the book's main ideas and concepts. Doing so is made even easier by the book's style, which combines written explanations, practical examples, and case studies. Most examples, even the ones in the theory-heavy Chapter 2, are from the field of banking and client advising and involve client decisions and financial products, making for great illustrations. For readers of a more theoretical bent, the authors include "math boxes" setting out the mathematical foundations of selected theories and examples. The fact that it is perfectly possible to skip the math boxes and still follow the main arguments of the book should further increase the book's appeal to practitioners. Another positive feature of the book is its website (www.bfpb.ch), from which the Excel tools applied in the practically-oriented parts of the book can be downloaded free of charge. Overall, the book is a very entertaining read on highly relevant and practical issues, and is recommended for private bankers as well as for financial economists with little or no prior exposure to behavioral finance.